

D.T.E. 98-32
Marketer Response to DTE Questions
May 1, 1998

Introduction

The Competitive Marketers ("Marketers") comprise an ad hoc group of collaborative participants.¹ The group includes companies that range from large national marketing companies to smaller companies focused on retail marketing in New England and the Northeast. We are pleased to offer our joint responses to D.T.E. questions 2 through 10 attached.

It has now been two years since the Department initially considered the desirability of a mandatory or a voluntary capacity allocation program to implement unbundling on the Boston Gas system in DPU 96-50. Much experience has been gained in that time frame, in Massachusetts and in a number of other jurisdictions. State regulatory commissions throughout the country have established gas unbundling programs in their states. Many of the commissions evaluate the progress of the programs on an ongoing basis. The most successful programs feature voluntary capacity disposition. Moreover, in Ohio, Pennsylvania, and Maryland, local distribution companies which initially implemented mandatory capacity release programs have revised them to provide for voluntary release. We will discuss experience in some of these states as well as others in our responses to Department questions.

The primary reason why programs have failed is that the free market has not been allowed the room to operate. A number of barriers have been erected that preclude the marketer from offering the kinds of savings required in order to entice the customer away from the incumbent utility. The most significant barrier has been the imposition of a mandatory capacity assignment program on the competitive market. Mandatory capacity assignment programs transfer the utility's cost position to the marketer. It is common experience in the marketplace that customers will generally not consider moving away from the utility for less than ten percent savings on their overall bill. When given the utility's capacity cost structure to work with, and layering upon that the costs of acquiring and enrolling a customer, the administrative costs of transactions between the marketer and the utility, the costs of operating under the operating terms and conditions of the utility, and the costs of complying with consumer protection regulations, it is no wonder that marketers have had little room to offer the savings customers require to switch.

¹ The Marketers include the following organizations: AllEnergy Marketing Company, L.L.C., The Eastern Group, EnergyEXPRESS, EnergyVision, Enron Energy Services, Global Petroleum Corp., the Market Access Coalition, PG&E Energy Services, Select Energy, Inc. and Utilicorp United, Inc. Descriptions of each participant were included in Attachment C, Appendix A in the Collaborative Status Report filed with the Department on March 18, 1997 with the exception of the Eastern Group and Global Petroleum Corp. who filed letters of support subsequent to the March 18th filing.

The competitive market can work. Marketers can offer customers savings by delivering to the city gate for less than the utility. These savings will result from three different avenues: 1) Marketers will buy the commodity cheaper; 2) Marketers will configure more efficient capacity portfolios; and 3) Marketers will achieve efficiencies of scale. However, without the freedom to configure their portfolios differently and more efficiently than the utilities, the most significant source of savings during the transition is lost. Without these portfolio configuration savings to offer customers, the utility remains entrenched and maintains a significant competitive advantage.

Competition has a proven history of providing benefits. It is not neat, it is not orderly, and it cannot be planned. It also can only become established and work in areas where there is an opportunity to earn a profit. That is what motivates competition. Potential competitors will only make investments and subject them to market risk where there is a reasonable opportunity to earn a profit.

It is instructive to consider the experience of deregulating the interstate pipelines. Competition in the interstate gas markets developed because the interstate pipelines had above-market purchase contracts as a result of a series of historic events. The new competitors were able to sell gas for significantly below those prices. When the market first opened, the potential margins were quite high, and numerous competitors rushed into the market. However, as one would expect, those competitors engaged in vigorous competition, until the same market that had started with attractive margins reached the point where customers routinely switched suppliers for a tenth of a cent savings. In that market, efficiency, knowledge, understanding of transportation and the introduction of new products became the way to survive and prosper. In turn, competition produced new reserves at prices far below any that had been estimated under the prior regulatory regime. More efficient utilization of the existing transportation and storage network also resulted, as did new and innovative products as customers received reasonable price signals and were encouraged to seek more efficient alternatives that more closely matched their requirements. None of this would have resulted if new entrants had been required to pay the same above market prices for gas faced by the pipelines.

Competition developed in the interstate telephone market because of similar opportunities for the new competitors to avoid some of the entrenched costs faced by the existing dominant providers as a result of the prior regulatory regime. Again, there were good profit opportunities in the beginning, but this was followed by extremely vigorous competition, resulting in falling prices and new and innovative services.

Competition will not fully develop where there is head on competition with a utility that is selling gas in retail markets unless there is profit opportunity to get the market established. Programs that layer costs onto the competitive market costs until they approximate or exceed those of the LDC pose insurmountable barriers to competition. Without the profit opportunity, the entrenched provider will retain its existing customer base,

and those customers will never receive the benefits of additional competition. New entrants face extensive costs to acquire and begin service to a new customer.

The fact that the LDC can serve these customers at a rate that new entrants cannot match due to the imposition of non-market costs does not mean that the LDC price is the lowest available price, or that it leads to efficiency. It just means that the LDC has a significant advantage because of its entrenched status and the inappropriate costs imposed on market participants, and therefore is able to effectively preclude other market entrants. If the market is opened without the burden of these unnecessary costs, competitors will find less expensive and better ways to reliably provide the same and new, innovative services.

Price reductions are the sweet fruit of the competition tree. While the fruit is delicious, the tree is essential. For it is only genuine competition that can protect the public interest as the Department withdraws from the price regulation of generations.

It is this experience that guides us as we make our recommendations to the Department for the most efficient ways to open the competitive gas retail market. Our responses to the Department's questions that follow should be read in the context of this experience.

2. Capacity Assignment Principles.

a) Discuss the merits and limitations of the voluntary assignment and mandatory capacity assignment processes that have been suggested as the way by which current LDC capacity should be made available to end-users or marketers or, alternatively, remain with the LDC even if the LDC no longer requires that capacity in the transition to an unbundled market. Describe how each alternative has been used to implement unbundling in other jurisdictions.

b) Discuss the merits and limitations of the portfolio auction process. The discussion should consider the use of the portfolio auction with the separate alternatives of mandatory assignment and voluntary assumption of capacity to end-users that choose another source for their gas supply. Describe how these alternatives have been used to implement unbundling in other jurisdictions. Indicate the criteria, other than price, that should be considered in determining which bidder should be selected. Discuss the issue of market power and indicate what types of restrictions, if any, should be placed on the winning bidder to address potential affiliate abuses.

Although the Marketers address this question directly below, it is critical as an initial matter to understand the distinction between mandatory capacity assignment, on the one hand, and portfolio auctions, on the other. Put simply, the question of whether a portfolio auction process should be adopted is distinct from whether a voluntary or mandatory capacity assignment program is appropriate. While some LDCs have proposed a portfolio auction that would include mandatory capacity assignment, which the Marketers oppose for the reasons set forth in part (b), the Marketers assert that if an auction is adopted it should be modified by substituting a voluntary capacity assignment program for the unnecessary and unwarranted mandatory regime proposed by the LDCs. Adopting a voluntary release mechanism is absolutely critical to the long-term success of the competitive retail market, and even the LDCs themselves recognize that a voluntary release program can successfully coexist with their portfolio auction proposal.² Thus, because a portfolio auction procedure raises separate policy and competitive concerns than the kind of capacity assignment program that is established, i.e., voluntary or mandatory, the Marketers will address these issues separately.

For convenience, the Marketers address the two subquestions presented in this Question No. 2 separately; mandatory v. voluntary capacity assignment

² LDC Portfolio Auction Proposal, page 6, n.4 (submitted as part of the Massachusetts Gas Unbundling Collaborative Status Report ("Status Report")).

programs; and a description of how each has been used to achieve unbundling in other jurisdictions.

(a) Voluntary v. Mandatory Capacity Assignment.

General Overview

Experience demonstrates that the most important ingredient of a successful unbundling initiative is a voluntary capacity assignment program in which marketers are able to integrate capacity formerly held by the LDCs into their existing gas and capacity portfolios in the most economically efficient manner. In this way, marketers will be able to compete in unbundled retail markets by offering lower prices to consumers.

The implementation of a voluntary capacity assignment program is particularly important during the transition to competition. During that period, LDCs remain in the merchant function and, as a result, consumers require greater savings to overcome the inertia created by their traditional reliance on the LDC as the sole gas service provider. Thus, marketers who are unable to aggregate portions of the LDCs' capacity with their own portfolios in an efficient manner will be unable to deliver real savings to consumers and hence will not be able to participate in the market. As a result, consumers will be denied choices that would otherwise be available.

If one goal of competition is to provide competitive prices for consumers, a mandatory assignment procedure makes little sense. Put simply, why should marketers be required to take assignment of upstream capacity that was used to provide a bundled city-gate service in a noncompetitive market if they do not require that capacity today to serve their new load of converting customers? Such a mandatory assignment provision increases costs, discourages innovation and thwarts competition.

The LDCs advance four alleged benefits of a mandatory assignment program: (1) elimination of stranded costs; (2) preservation of reliable service; (3) elimination of the "first mover" advantage; and (4) establishment of identical cost structures for all competitors. The Marketers address each in turn and demonstrate not only why these alleged benefits are illusory, but why voluntary programs are the only means of promoting vibrant supplier competition in Massachusetts that will benefit all consumers.

(1) Elimination of Stranded Costs

Mandatory assignment of upstream capacity may initially appeal to regulators because it eliminates the possibility that non-competitive upstream assets will be identified and stranded. Because consumers are forced to take

LDC capacity at or above the maximum rate allowed by FERC³ regardless of the actual market value of the capacity, the LDCs claim that this process "maximizes the bid value" of the capacity. That view is short-sighted.⁴ The real result of mandatory assignment is to deny consumers the larger, more permanent benefits that result from a robust competitive market. Upstream assets with a regulated price above their market value will still be stranded, even under a mandatory assignment procedure, because marketers who are forced to purchase uneconomic assets must reflect that cost in their price of gas. Since marketers are free to offer different prices to different consumers, under a mandatory plan, the Department will have no control over how those costs are allocated.

In a voluntary assignment scenario, the Department will have the ability to ensure an equitable allocation of stranded costs when assets are so identified under a voluntary allocation mechanism. If unbundling is achieved effectively, i.e., by implementing an efficient voluntary assignment proposal such as that proposed by the Marketers, LDCs will incur only minimal, if any, transition costs. The notion that voluntary assignment programs and consumer choice "create" transition costs is foolhardy. To the contrary, such costs are already imbedded in Massachusetts ratepayers' existing rates. Converting customers do not cause transition costs; such costs are identified during a LDC's move from a regulated to a competitive market. Because all customers benefit from the opportunities made possible in a competitive market, it is reasonable that all customers pay for the cost to transition to such a market.

(2) Preservation of Reliable Service

The LDCs contend that mandatory assignment will ensure service reliability. LDCs have assembled integrated portfolios for current and future potential transportation and sales of gas. These portfolios are designed to balance cost with reliability and efficiency and reflect individual characteristics of each LDC's system. LDCs argue that mandatory assignment of upstream resources preserves this balance and transfers the reliability of the portfolio to the emerging competitive market.⁵ While these portfolios may have been efficient in the pre-competitive era of monopoly

³ Some LDCs charge the weighted average capacity cost of their system portfolio which may be higher than the path cost of the capacity allocated to the marketer.

⁴ Within the next decade many upstream transportation and storage contracts will expire. (see Attachment A) Through a voluntary capacity program, upon recontracting, the market value of the capacity will become apparent.

⁵ Portfolio Auction Proposal, pages 1-2.

LDC service, they will not optimize savings or reliability in the future competitive market when multiple suppliers of natural gas compete.

These same reliability concerns were vociferously raised by interstate pipelines when the FERC unbundled interstate gas service six years ago. Today, interstate pipeline service is more reliable than it has ever been due to the discipline that competition has brought to the market. Likewise, the reliability concerns traditionally voiced by LDCs – that they will lose control of their systems and that it will become increasingly difficult to expand their systems because they lack necessary supply -- can be addressed in several ways without a mandatory program that thwarts competition: (1) through coordination and cooperation between LDCs and marketers and more efficient management of upstream assets by marketers whose portfolios may be far more diverse than those of the LDCs and (2) through adoption by LDCs of OFO provisions in their tariffs and retention of sufficient assets to ensure system reliability. The Marketers support any such collaborative measures that would maintain system reliability to the benefit of the LDCs, suppliers and consumers.

The notion that the status quo preserves reliability is simply inaccurate. Mandatory assignment at maximum rates forces the LDCs' historic cost structure upon potential competitors in the unbundled market. The new suppliers can only bring efficiencies to consumers by combining their existing portfolios with those components of the LDCs' interstate capacity that are valuable to consumers in the new marketplace. Reliability is ensured not because the historic status quo is maintained but because marketers will acquire capacity from LDCs and the market that ensures the reliability of their individual supply and capacity portfolios.

(3) Elimination of the "First-Mover" Problem

The LDCs also claim that a mandatory plan avoids the inequitable cost shifting and cross-subsidization of "first-mover" transportation customers by the remaining transportation customers, i.e., the notion that the first customers to convert will receive the most valuable capacity paths and assets, which will be subsidized by the transportation customers who convert subsequently and receive inferior transportation assets.⁶ However, as noted above, because all consumers have the opportunity to benefit from the options available in a competitive market, no inequitable cost shifting results under a voluntary plan. Those who choose not to choose are making a choice. Moreover, the Competitive Marketers' "Unbundling for Competition"

⁶ Status Report at 12.

Proposal contains provisions that eliminate any possible "first mover" advantage.

(4) Establishment of Identical Cost Structure

The LDCs also claim that a benefit of a mandatory program is that "marketers will begin to compete with virtually identical cost structures."⁷ This is a fallacy from day one. Marketers have existing portfolios that differ from each other. These portfolios most likely have differing cost structures. Furthermore, to force identical cost structures on the market is the antithesis of competition - if all suppliers in a market are forced to assume the same cost position, as occurs under a mandatory plan, competition will be inhibited, not enhanced.

Conclusion

The Department should not lose sight of the primary objective of this initiative - to provide Massachusetts consumers with the broadest opportunity to receive the benefits inherent in a competitive market. If the goal was instead to maintain the status quo where all consumers bear the costs associated with the LDCs' historic supply function, the Department need not have initiated this ambitious effort to allow all consumers to choose their gas suppliers by November 1, 1998. The "Unbundling for Competition" plan advanced by the Marketers includes provisions that ensure the greatest choices, and hence savings, for consumers. The plan will also minimize transition costs, while favorably resolving the issues raised by the LDCs.

(b) Describe how each alternative has been used to implement unbundling in other jurisdictions.

Real-world experience since the advent of unbundling demonstrates that voluntary assignment is not merely a theoretical policy argument, but a necessary prerequisite to the development of a competitive marketplace. It is the Marketer's general experience in other jurisdictions that voluntary capacity assignment proposals have attracted broad marketer participation, which has led to competitive savings for consumers.

Marketers have generally declined to participate in jurisdictions implementing mandatory assignment programs because of their inability under such a program to offer meaningful savings to consumers. Under a mandatory regime, marketers are encouraged to target only customers whose capacity allocation and costs are lower than the cost structure reflected in the CGA. This cream skimming is expensive and inefficient, results in cost shifting to remaining customers, and will not result in the broad availability of competitive pricing to consumers. With limited marketer

⁷ Status Report at 12.

participation, such programs have generally not been successful. A jurisdiction by jurisdiction analysis detailing the results of the various unbundling programs is provided in response to Question 9.

(c) Portfolio Auction

As discussed above, the desirability of a portfolio auction as proposed by some LDCs is a policy issue separate from the methodology for the allocation of capacity. However, if a portfolio auction is ordered or allowed by the Department, it has implications on the structure of the capacity allocation plan that is adopted if the Department's primary purpose is to open up the Massachusetts market to competition.

Portfolio auction plans in general create competitive market barriers in two major areas. The first relates to pricing and the second relates to market power.

1) Pricing

The LDC's cost of gas is the threshold price which all marketers must beat to acquire customers, and will remain the benchmark price throughout the transition. The portfolio auction substitutes a wholesale market price for the LDC's regulated price. A portfolio auction that yields savings over the LDC managed portfolio, and where customers continue to bear the risk of volume fluctuations for the LDC and now the wholesaler, places another hurdle in front of the development of the retail competitive market. Consumers are already customers of the LDC and will demand significant savings before they will switch to the competitive market. The wholesale marketer who wins the bid does not have the customer acquisition or ongoing administrative costs of the retail marketer. The LDC has absorbed those costs. The playing field starts off tilted in favor of the wholesaler and LDC. The LDCs express concern about minimizing the risks to the wholesale marketer while at the same time are imposing more significant business risks on retail marketers.

The value a retail marketer brings to the commodity market includes the ability to buy gas and deliver it to the city gate cheaper than the LDC. This ability comes about as the result of more efficient sourcing of gas, more efficient portfolio management enabled by scale, and more efficient portfolio procurement. The wholesaler, by virtue of winning the bid to supply the default retail market, will get the scale the retail marketer is striving for up front without moving the default customers into the competitive market. Wholesale auctions may offer short term initial savings to customers, but will result in less savings in the long term because it will delay the development of a robust retail competitive market in which there are many buyers and many sellers. This is because the wholesale scheme would simply replace a regulated monopoly with an unregulated one.

2) Market Power

The LDC Auction proposal also results in placing an entire distribution company's portfolio in the hands of a single unregulated entity. The transfer of this capacity may act as a market barrier to many entrants due to market power that may be exerted by the wholesale marketer. There are no regulations governing the transactions that occur between an unregulated wholesaler and their retail affiliate, or the unregulated wholesaler and the utility's affiliate, nor is it clear whether the DTE has jurisdiction over those transactions. There is nothing to preclude a wholesaler from advantaging their affiliate or others to the detriment of other unregulated market participants.

If the resource portfolio remains in the hands of the LDC throughout the transition, the LDC is regulated and transactions can be monitored. If the LDC is showing preference for one marketer over another, the behavior can be brought before the Department for resolution. There is no such forum in the unregulated market.

If the DTE approves any element of the portfolio auction, the Marketers strongly recommend the development of strong, enforceable codes of conduct governing the relationships between 1) the wholesaler and any retail affiliates, 2) the wholesaler and the LDC whose assets the wholesaler is managing, and 3) the wholesaler and any of the LDC's affiliates.

3) Other Auction Elements of Concern

The LDC Auction Proposal has other elements that could present further barriers to the development of a competitive market if implemented. These elements include caps on migration levels, which are not conducive to an ongoing retail market presence. If LDCs are concerned about customer service, they will want to provide incentives for marketers to retain local offices. Marketers want to open and support local offices, and make full use of local media outlets, but it makes no sense to do so if open season enrollment periods restrict the time periods during which marketers can use these resources. Migration caps are not necessary to minimize wholesaler risk, even with a voluntary program. A mechanism to remove the customer's pro rata share of capacity from the portfolio, even if an auction were to be coupled with a voluntary program, would neutralize wholesaler risk. Unselected capacity could then be treated under a separate arrangement that will provide incentives for the portfolio manager to garner the best mitigation value for customers.

If a capacity auction is allowed, it is imperative that the capacity allocation program be voluntary, and contain additional elements to the

voluntary scheme proposed by the marketers in the March 18 Status report. In order to provide retail marketers an opportunity to compete, marketers must have the maximum freedom possible to configure a portfolio that will yield lower costs. Coupling a mandatory program with a portfolio auction will make it virtually impossible to offer savings to any but a few of the largest customers with high load factors.

(d) Practical Experience

No broad based unbundling plans have been implemented in conjunction with a portfolio auction to our knowledge. Providence Gas Company implemented unbundling to a limited group of its largest customers under a mandatory allocation scheme, and in conjunction with a portfolio auction. These customers were the most likely for marketers to be able to offer savings. Marketers do not believe that this program will be successful if rolled out to smaller commercial, industrial and residential customers.⁸

Other companies who have implemented portfolio outsourcing arrangements have done so on a one year basis and have not opened up all of their markets to competition. These portfolio management arrangements include those in place between Colonial Gas Co. and MidCon, Yankee Gas Co. and Engage, and Brooklyn Union and Enron. Moreover, none of these companies have mandatory capacity allocation programs associated with the markets that are open to competition.

⁸ Marketers were generally unaware that ProvGas was in the process of implementing its portfolio auction and were not able to comment on its impacts on the Rhode Island competitive market upon its submission to the PUC. Marketers were notified by ProvGas when they issued their CGA compliance filing with the PUC.

3. Cost Responsibility

Discuss the role of current Department policy concerning cost responsibility and cost allocation when providing for cost recovery of gas supply resources. Indicate the extent to which each of the proposals for capacity assignment is consistent with existing precedent.

Discuss how a voluntary assignment program could be implemented in a way that would ensure that no stranded costs might result. If some stranded assets and costs are identified as a result of the voluntary assumption of capacity, how might those costs be recovered without imposing any additional charges upon the non-switching end-users or upon the LDCs? If transportation customers pay a proportional share of the stranded costs, will the playing field be level or will marketers be at a disadvantage and unable to compete?

Department policy with respect to cost recovery of gas supply resources has been moving toward a rate structure that is more consistent with the Department goals of simplicity, fairness, efficiency, continuity and earnings stability. However, in instances involving industry restructuring associated with FERC Order No. 636, or settlements involving cost recovery of environmental remediation of past manufactured gas practices, the Department has recognized that these costs should be spread equally across all firm tariff customers.

The LDC's mandatory proposal, based on the marketers' experience, will raise continuity concerns due to the rate design differences between the capacity allocation methodology and the CGA billed to customers. These rate design differences are discriminatory in that they preclude broad based availability for all customers to the competitive market and will exclude large numbers of customers from participating in the market. This also raises issues of fairness to customers who cannot achieve economic access to the competitive market. As customers with better load factors than average leave the system, the cost of their capacity will be less than they are contributing through the CGA. This will increase the average cost paid by customers who remain and who have less opportunity to switch.

The voluntary proposal put forth by the marketers is fair and efficient because, unlike the mandatory proposal, it allows all customers to have access to the competitive market. Prices offered by the market will reflect market based costs and will be more efficient than prices that under a mandatory scheme would necessarily incorporate the cost structure of the utility. The voluntary proposal also provides for rate continuity through a cap on potential rate impacts to individual customers, or through deferral of payment of costs until a significant portion of the market has already enjoyed the benefits of the competitive market.

Consistent with DTE past precedent in FERC Order No. 636 recovery and Environmental Remediation recovery, the voluntary proposal provides all customers with the opportunity to benefit from restructuring, while requiring that all customers bear the costs of transitioning into that opportunity. We believe this to be a fair allocation of the costs of restructuring to allow competition to regulate the retail natural gas market.

While there have been some suggestions that a voluntary capacity program could be designed while requiring the marketer to pay the utility's regulated cost for capacity, these are merely economic mandatory programs that allow marketers marginal operational efficiencies. For reasons discussed in our introduction, imposition of the utilities' costs on competitive marketers will not allow marketers enough room to compete with the entrenched utilities. Marketers cannot squeeze savings out of imposed costs at levels sufficient to move the market. Customers will remain with the known and comfortable utility unless they reach threshold levels of savings to entice them to venture into a brand new competitive market. Given the cost structure of a voluntary program that allows a marketer to control their own cost destiny, competitors will begin to compete vigorously to win over customers. The market will develop quickly as we have seen at the interstate level and other industries, and consumers will win through lower prices and new products not previously available.

4. Reliability of Unbundled Service

Identify those elements of unbundled service in which the introduction of unbundling might lead to a decline in the reliability of service. Discuss fully how reliability might be affected by particular elements of each unbundling option presented.

As part of our response to this question, we want to be clear on our interpretation of the question. Our discussion of reliability hinges on our interpretation of the phrase “each unbundling option presented” as meaning voluntary vs. mandatory assignment of capacity. Based on that understanding, the discussion below compares and contrasts reliability of service under a voluntary program vs. a mandatory program for the disposition of capacity and other upstream assets.

As long as all market participants adhere to collaborative processes to guide the operational, technical, systems and communications aspects of unbundling, regardless of which capacity disposition option is pursued, - voluntary or mandatory - reliability will not suffer. This statement is based on what the gas industry has learned from the unbundling of the interstate pipeline portion of the industry. Despite many claims regarding degradation of reliability, history shows that pipeline reliability *increased* with the introduction of competition and unbundling.

During the transition to an unbundled interstate/wholesale market, many critics voiced concerns that reliability would be sacrificed due to reduced regulatory oversight and the resulting loss of control by regulators to assign certain responsibilities to particular market parties. A good example where these concerns over unbundling and competition existed was related to the intermediary role pipelines played prior to unbundling relative to the attachment of new supply resources to interstate pipelines. The concern stemmed from the fact that in the merchant role interstate pipelines had historically served as the party responsible for ensuring that new supply resources were connected to the interstate pipeline network. By removing the pipeline from the merchant role, there was concern that the market would not assume that function, and reliability would be seriously threatened.

Instead of these fears materializing, other entities saw an opportunity to step into this role by providing the commercial, financial and legal needs, and by devising new and improved ways for supply resources to get to market. Degraded reliability never materialized. In fact, not only have new supplies have come on line, but they have also reflected competitive market price signals which have allowed for a more efficient matching of the supply source with the pipeline delivery point.

We believe that competition is the best regulator where natural monopolies no longer exist. It will provide the appropriate price signals for the market to adjust supply to demand. As in the example above, new entities will step in and fulfill

newly unregulated roles and provide new services and the efficiencies characteristic of a competitive environment.

The difference between the two capacity disposition proposals is an economic one – albeit, one with very different consequences for the viability of the competitive retail market -- in which the issue is not whether the capacity will be there to support reliable service, but rather how the capacity is allocated to various market participants.

There are sufficient penalties for less than reliable service already in place, and more are being proposed as part of the Terms & Conditions which have been developed as part of this Collaborative process and enjoy consensus within the group. Properly designed OFO provisions and operating penalties provide incentives for market participants to ensure that natural gas service in Massachusetts achieves or exceeds existing reliability standards. Please see Response 6 for a full discussion of how the Marketers propose to ensure reliability and adequacy of service during the transition to full unbundling and after full unbundling is achieved.

5. **Regulatory Oversight**

Discuss the matters for which regulatory oversight will be required during the transition to fully unbundled service and after full unbundling. Indicate the ways by which such oversight might be implemented in a manner which will not discourage the development and continued viability of competitive markets but will meet the public interest needs.

Marketers are encouraged by the DTE's recognition in this question that overly burdensome regulation has a very chilling impact on developing markets. Having said that, Marketers do, however, envision an ongoing and important role for the DTE in unbundled, deregulated, competitive gas markets.

The most critical role we envision for the DTE during the transition is that of a primary educator of the public as we unbundle and markets open up. This effort must be coordinated and commenced almost immediately. See our response to Question 10 for examples of how regulatory commissions in other states have fulfilled this role.

Continued regulatory oversight will be necessary in order to determine, at some future date and on an ongoing basis, that the goals and objectives of unbundling have been met. We view the DTE as the Steward of Competition - the body responsible for determining that competitive markets are developing and thriving, and in the absence of that finding, taking necessary further actions to jump start markets or refine programs.

Market power issues will continue to require DTE monitoring and oversight. Affiliate abuse claims and findings should be handled by the DTE. These issues will require monitoring both during the transition period *and* after full unbundling. At a minimum, the Marketers recommend that the DTE monitor the market share held by the LDCs' affiliates and report that information using blind surveys.

Continued regulatory oversight and involvement will be beneficial during the transition to full unbundling in the form of monitoring reliability (see Response to Question 4 above), assessing the evolution of capacity markets, including facilitating discussions among parties on planning for future capacity needs. The DTE will be a critical player in the designing processes for recontracting, evaluating the success of capacity disposition and if necessary, reconsidering issues involved in upstream assets.

The DTE will also play an important role in the consideration of further unbundling of downstream assets (see Response to Question 7 below). In addition, the DTE will also need to monitor the exit of LDCs from the merchant function to ensure that there is an orderly process for this exit. Monitoring of ongoing consumer

education and information to ensure that these programs are having their intended impacts should be undertaken by the DTE.

Finally and obviously, the DTE will continue to regulate the distribution service of LDCs both during the transition and after full unbundling.

6. Responsibility for Reliable and Adequate Service

Discuss the responsibility for assuring reliable and adequate service to all end-users during the transition to unbundled service. Include a full discussion of the means by which the LDC and marketing parties could cooperate to assure the availability of the capacity required to provide continued reliable service, including a discussion of responsibility for new capacity contracts, contract renewals or terminations. Include a full discussion of the LDC's or marketer's obligation to serve customers during the transition to unbundling.

Marketers are as concerned about reliability of service as LDCs and regulators. This is because marketers understand that any degradation in reliability will be perceived as marketer-caused, whether or not this is the case.

Marketers are also of the opinion that the best way to achieve reliability is to create a robustly competitive market, where marketers who fail to meet or exceed reliability standards find themselves without customers to serve. Mechanisms to promote reliability are currently in place: penalties for non-performance, credit worthiness standards, consumer protections all serve to encourage, and indeed require, that Marketers operate in a safe and reliable manner.

It is important to note that participants in the natural gas industry have much more experience in this arena than our colleagues in the electric industry. Not only is the experience of unbundling the interstate pipelines illustrative of how new industry relationships successfully address reliability issues, larger customers have been transporting gas for many years, and the marketers who deliver to these customers have a demonstrated history of reliable operations. We contrast this with the electric industry where there has been no comparable experience to date, and conclude that there is no need for additional detailed lengthy requirements for operational reliability.

In order to maintain reliability during the transition period and beyond, all parties to the process need to recognize and adopt new communications protocols and paradigms. Decisions which have historically been made unilaterally by LDCs must be made in a more collaborative manner. In successful unbundling programs, LDCs come to view Marketers as their partners in reliability. In some jurisdictions, during critical periods, LDCs call on Marketers to help the LDC maintain system integrity. Most, if not all, Marketers stand ready to respond to these requests and cooperate to get the system past emergencies. The ability to respond, however, rests on the development of systems and processes which encourage lots of communication and understanding of all parties' needs.

Planning for growth on the system is another area where the LDC has historically been the responsible party, and therefore has made unilateral decisions

concerning acquisition of capacity to serve growth. It is not too early to give the Marketers a seat at the table at which planning for growth is conducted. For while Marketers anticipate that it will always be the LDCs' responsibility to design, build and maintain the distribution system to handle growth, collaboration in capacity planning to meet growth should be the model of the future. In this way, risks are shared and future costs will not be "stranded." The LDCs should be encouraged to share growth projections with marketers, and let marketers be responsible for bringing capacity to the market to meet the growth. To the extent a Marketer has overestimated the need for capacity to serve his own customers, capacity can be bought/sold/traded with other Marketers on the system. In this way, the Marketer assumes the business risk of acquiring the capacity.

The market itself will administer the ultimate test of the prudence of capacity decisions. Historically the regulator has substituted his or her judgment for that of the market to determine if capacity decisions have been prudent. For many LDCs, the specter of a prudence review has been the primary driver of capacity decisions, and in some cases, limited the creativity of capacity decisions. Marketers are willing and able to take more business risk in making capacity acquisitions. To the extent a Marketer has overestimated market value, in a competitive market, the customer has the option to switch to another Marketer with a different portfolio. LDCs should be willing to shed, or at least share the risk of capacity planning with Marketers. See also our response to Question 5, above. The planning for growth, and development of communications protocols are ripe for further Collaborative meetings held under the auspices of the DTE.

As long as the current free and frank exchange of ideas continues between LDCs and marketers, it is our position that reliability will not be affected by unbundling of services.

The Obligation to Serve/Supplier of Last Resort issue is an extension of the reliability question, and may be further analyzed as 3 components: 1) service to those customers who choose not to choose, 2) service to those customers who are not chosen by a marketer, and 3) service to those whose Marketer fails to deliver.

The Marketers would propose that the Supplier of Last Resort function, while perhaps logically resting with the LDC during the transition period, should be subject to competitive bidding in the future. As LDCs exit the merchant function, they should shed the role of default service provider. In other jurisdictions we are seeing evidence that the market places value on this type of service.

Competitive bidding as proposed is envisioned as part of the process by which the LDC's execute an orderly exit from the merchant function. However, particularly if the DTE orders an auction of assets, issues of market power must be

carefully analyzed in order that the process not create a mega-competitor with control over upstream assets as well as the market for default service.

7. **Downstream Assets**

Discuss the means by which downstream capacity and assets might be allocated under unbundling and the process by which such decisions might be initiated and adopted.

At this time, the Marketers would propose that consideration of the unbundling of downstream assets be subject to further Collaborative meetings and discussions, under the guidance of the DTE. As we stated in our March 18 filing with the DTE, Massachusetts LDC's should develop cost based tariffs for the offering of downstream asset-related services. To the extent the companies find themselves with unsubscribed or undersubscribed assets, an incremental offering at market prices should then be developed. After we have had some experience with the market for the services using these assets, the DTE and all parties should evaluate the level of market activity and the experience with these offerings. Based on that evaluation, the Collaborative should develop recommendations for further unbundling if appropriate to reflect, for example, terminaling, storage and vaporization components.

We believe that this phased approach to unbundling will be beneficial for all parties.

8. Statutory or Regulatory Changes Required to Implement Gas Unbundling

Please identify and discuss any statutory or other changes that might be required for the Department to implement any element of the unbundling process.

The vast majority of state utility commissions throughout the United States that have mandated or otherwise approved gas unbundling and retail access plans have done so under existing statutory authority and without the need for changes in law or overall commission rules. Although states such as Georgia enacted new laws to mandate comprehensive gas industry restructuring (dealing with ultimate issues such as procurement function divestiture), the implementation of gas unbundling programs in the other active unbundling states has not required any statutory or regulatory changes. Massachusetts itself has gone forward with unbundling programs dealing with most of the elements of retail access for Bay State Gas and Boston Gas without the need for new legislative enactments or rulemakings.

The DTE has sufficient regulatory authority under M.G.L. Chapter 164 at this time to undertake gas unbundling for each of the Commonwealth's LDCs. For example, the unbundling of rates and allocation of upstream pipeline capacity, storage, and on-system assets is well within the DTE's broad authority under Chapter 164 over LDC rates, and terms and conditions of service. Moreover, at the interstate level, FERC capacity assignment rules are well established, allowing for capacity allocation by LDCs. The DTE's broad authority also captures the development of charges to recover all or a portion of transition or stranded costs that may result from unbundling and allocating these assets. Certainly, other critical elements of the unbundling process such as the establishment of pooling, nomination, and balancing regimes is similarly captured by the DTE's supervisory authority over LDCs under C. 164, including §§76 and 94 *et al.* The DTE's intention to implement comprehensive rate and service unbundling programs is within its statutory authority. Nor would the DTE be treading on new ground given the actions taken by other state commissions regionally and nationally.

In terms of more fundamental industry restructuring initiatives, the DTE may be guided by legislative requirements such as M.G.L. Chapter 164, § 21. Such provisions should be narrowly read to apply only to the local distribution function and not the utilities' procurement function (including upstream capacity disposition) and, therefore, would not directly prohibit the auction process, backstop transfer, or divestiture of the merchant function by the LDCs.

9. Domestic Experience with Unbundled Service

Identify those programs of unbundling that have been in effect or proposed for other jurisdictions in the United States. For each program:

- (a) Indicate the dates on which the program was approved, program size limitations, enrollments initiated, enrollment terminated, service terminated;**
- (b) Review the extent and monthly rate of customer migration in these other programs, together with the nature of the enrollment period (fixed or rolling);**
- (c) Describe the principal attributes including, but not limited, voluntary or mandatory assumption and cost responsibility;**
- (d) Discuss the impact upon each major class of stakeholder including, but not limited o, the LDC and residential end-users;**
- (e) Discuss the way(s) by which decisions are to be reached on capital renewal and capacity additions necessary to provide for system growth;**
- (f) Indicate the marketers (including affiliation) that participate in any residential unbundling programs;**
- (g) Discuss the ways by which capacity assignments were made and discuss the extent to which the limited extent of a pilot program limits the significance of that experience when developing a program for phased-in unbundling;**
- (h) Identify the cost responsibility for stranded capacity and the amount of those stranded costs;**
- (i) Indicate the extent to which stranded costs were reduced through mitigation; and**
- (j) Discuss the extent to which the requirement for mandatory assignment or the portfolio auction of the LDC capacity appears to have affected the development of those unbundling programs.**

As the gas industry continues to develop into a competitive environment, more than 20 states have implemented some form of residential customer choice.⁹ The unbundling programs vary from being small pilot programs to providing choice to all customers within the state or an individual utility's service territory. What the Marketers have found is that the process of gathering accurate and comprehensive information about each program requires the assistance and cooperation of the commissions, utilities, marketers and consumer advocates. In addition, the process is very time consuming as information tends to trickle in from all of the different stakeholders. With this said, the marketers have provided information in three key states that have some of the longest and most extensive history in

⁹ AGA "Providing New Services to Residential Customers: A Summary of Pilot Programs and Unbundling Initiatives"

offering customer choice to residential customers.¹⁰ Attached please find summaries and supporting documentation for California, Ohio and Maryland.

The Marketers believe that the information contained herein supports the need for a voluntary disposition of capacity. For example, California has more than seven years of experience in offering customer choice to residential customers where the core aggregators are required to take a pro rata assignment of capacity or the economic equivalent that has been reserved by gas utilities for core customers at 100 percent of the as-billed rate.¹¹ From the data gathered, it is self evident that customer choice of core customers in California has floundered. "Aggregators have directly attributed the lack of CAT program success to low profit margins, high transaction costs, and a failure to unbundle competitive services. If Aggregators were able to provide other services in addition to just the gas commodity (e.g. interstate transportation services), greater profit opportunities would attract competing providers and enhance choices available to even small consumers."¹²

In Maryland we have also learned a great deal. For example, Washington Gas Light's initial program that opened choice up to small commercial customers was originally a mandatory assignment program where one marketer participated. In subsequent years the program moved to a partial voluntary program and later to a full voluntary program for both residential and commercial customers where the number of providers more than quadrupled. Another important lesson was learned with both the residential and small commercial experience in Maryland . Mitigation efforts by WGL have proven to be successful. In fact, all residential customers have faced only a \$.60 yearly increase to date on their bills as a result of the program.¹³

Finally, we go to Ohio. It can be easily argued that Columbia of Ohio has one of the most successful customer choice programs for residential and small commercial customers in the country. The savings have exceeded \$7,300,000 to date, there are multiple competitive suppliers, there is a program for low income customers that have generated \$2,500,000 in savings and Columbia has filed an application with the Public Utilities Commission of Ohio

¹⁰ Many states have initiated small programs or have just enacted legislation where there isn't an extensive history from which to draw information or conclusions.

¹¹ AGA "Providing New Services to Residential Customers: A Summary of Pilot Programs and Unbundling Initiatives"

¹² California Public Utility Commission Division of Strategic Planning report "Strategies for Natural Gas Reform: Exploring Options for Converging Energy Markets".

¹³ Jim Wagner, Washington Gas Light

for a statewide roll out to the remaining 1.2 million customers within their service territory¹⁴. By far contrast, within the same state, we have the East Ohio Gas program. Not only are there fewer savings in a similar sized market and fewer marketers but also a marketing affiliate of the utility with 86% of the residential market share¹⁵. Important to note is that the Columbia of Ohio program was put together by a broad group of interested stakeholders where as the East Ohio program was not.

In conclusion, there are other examples of programs outside of Massachusetts that have not yet been addressed in our report due to time constraints and the amount of comprehensive information received regarding these programs to date. Nevertheless, there is a substantial amount of information based on years of experience in the states that have been presented. The Marketers hope that the aforementioned information is a useful tool when examining and deciding how capacity disposition should be handled in Massachusetts.

¹⁴ Report to the PUCO on the "COH Customer Choice Program" filed 3/98 Case No. 96-1113-GA-ATA. The 2.5 million in savings to the PIPP (Percentage of Income Payment Plan) customers is included in the 7.3 million in overall savings as a result of the program.

¹⁵ Report to the PUCO on the "Energy Choice Program" of East Ohio Gas Company Case No. 97-219-GA-GCR by Exeter Associates, Inc.

10. Consumer Education

Describe the extent and type of public and end-user education that will be required to the smooth implementation and viability of competitive, unbundled gas service. Discuss those efforts that have been implemented elsewhere with apparent success.

Consumer Education has proven to be an important and integral part of providing choice to the small consumer. In order to create awareness, reduce customer confusion and to encourage customer participation a number of key elements need to be addressed. First, educational materials should be simple and easy to understand. To raise awareness customers initially need to be educated as to why the market is opening and the benefits of choice, how the program works, how this affects the LDC, and how this affects reliability and safety.

Educational efforts have varied across the country. Generally, those efforts have included public forums, news media (news articles and releases) print materials (brochures, bill inserts, and fact sheets) paid advertising (billboards, radio, newspaper, TV, and the Internet). Information was also disseminated on a one on one basis through call centers, and meetings with public officials and community leaders.

The marketer group strongly believes that one of the most successful educational efforts has been that of the Public Utilities Commission of Ohio (PUCO), The Office of the Consumers Counsel (OCC), Columbia of Ohio (COH) and the participating marketers in support of the Columbia Customer Choice Program in Toledo. The Toledo program provides choice opportunity to approximately 180,000 residential and small commercial customers who use below 2,000 mcf per year. As of March 31, 1998, 54,319 customers have picked a new supplier¹⁶. With that said, customer satisfaction surveys of participants conducted by Sapperstein Associates on behalf of COH showed that 93% were satisfied with the "CHOICE" program, their new supplier, and the LDC. In addition surveys have shown that 80% of customers in the Toledo area are aware of the "CHOICE" program and at least three out of four participants felt selecting a new supplier was easy. Also, as a result of the marketing community's contribution to awareness 93% of small commercial customers and 83% of residential customers felt that their new supplier's advertisements, and promotional materials provided useful information in helping them make informed choices. Although the marketers' information proved to be the most useful, the PUCO, COH and the OCC also achieved 81%, 77% and 74% respectively for

¹⁶ The 59,319 customers participating does not include the 35,000 (approx.) Percentage of Income Payment Plan, "PIPP" customers being served by a competitive supplier through a separate RFP process.

residential customers.¹⁷ The extent and type of public and end-user education that was and is being used in the Toledo program is as follows:

Presentations

During the past 12 months COH reported making more than 130 group and individual presentations to a total audience of more than 3,300. The Office of the Consumers Counsel delivered 29 speeches to Toledo area residents. OCC estimates that they reached over 1,950 consumers.

Call Centers

The PUCO, OCC, LDC and the Marketers all used customer service call centers to address incoming inquiries. COH received more than 10,000 calls and the OCC Hotline staff received over 500 calls from consumers requesting information about the program.

Media

News releases: COH had 7 major news releases over the course of the last year. In addition, a large number of local daily, monthly and weekly newspapers through out Ohio ran over 56 news articles on the Toledo program. The OCC distributed the following four news releases¹⁸:

January, 1997	Program Announcement
February, 1997	Op Ed, <i>With Choice Comes Responsibility</i>
February, 1997	Article, <i>OCC Provides Help for Consumers Making Choice</i>
May, 1997	Article, <i>Competition Proves Beneficial for Choice Participants</i>

Paid Advertising

COH ran 13 ads in the largest local newspaper over the course of a four month period. With regards to monthly papers COH ran three advertisements. Finally, COH ran 32 promotional pieces in weekly papers during the months of January through March.

Outdoor boards were also used as another means of reaching customers. COH promoted the program on 14 boards strategically located throughout Lucas and Northern Wood counties. Marketers also placed advertising on local billboards. Radio was also used to raise awareness. COH used 11 weeks of targeted radio spots.

¹⁷ Columbia Gas of Ohio Customer CHOICE Program Report April 1997-March 1998 Filed with the PUCO 4/98

¹⁸ OCC information provided by Jackie Williams, Director of Consumer Services, Office of the Ohio Consumers' Counsel

Print Materials

Prior to the program roll out the OCC created and distributed about 5,000 fact sheets which provided information about the program, a contact list of qualified suppliers and outlined issues for consumers to consider when exercising choice. Columbia sent 340,000 bill inserts to both residential and small commercial customers in the Toledo area who were eligible to participate during the months of February and March. Also during February the PUCO sent 170,000 inserts titled "Ohio's Natural Gas Choice"(see attached). In March the Office of the Consumer's Counsel sent 170,000 inserts titled "You Can Choose Your Natural Gas Supplier"(see attached).

Other print materials included printed brochure. COH used approximately 46,000 brochures. 23,000 focused on the parameters of the program and the remaining 23,000 contained a list of qualified suppliers. With regards to fact sheets COH distributed approximately 5,000 fact sheets that were produced in a question and answer format. Marketers also used a large variety of printed materials including brochures and fact sheets, however the amount and distribution is unavailable.

Another area of the country that we feel provides a good example of outreach and education is in New York. The staff of the New York Department of Public Service put together and implemented an extensive consumer outreach and education program. One important note as it relates to New York is that all stakeholders, including marketers, were involved in the initial design of the consumer education materials. Experience has taught and we find this to be imperative, that there be marketer input on educational materials from the utilities as well as the Commissions. Rather than briefly outlining and summarizing the program we have attached the October 1996 "Report on Staff Consumer Outreach and Education Effort" as well as the "Report on Staff Consumer Outreach and Education Activities" in the Competitive Opportunities Case No. 94-E-0952.

In conclusion, what we have learned is that all stakeholders in the market play a vital role in getting the message out. The message needs to be clear and can be detailed. Our experience has taught us that we should not underestimate the extent to which consumers will be curious about the program and want technical or logistical questions answered. Finally, and most importantly, there needs to be open communication between stakeholders to provide a coordinated effort so as not to waste resources in achieving a successful consumer education program.